Not Just for Widows & Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market

Jennifer A. Frederick

Follow this and additional works at: https://ir.lawnet.fordham.edu/flr

Part of the Law Commons

Recommended Citation
Available at: https://ir.lawnet.fordham.edu/flr/vol64/iss1/4
NOTES

NOT JUST FOR WIDOWS & ORPHANS ANYMORE: THE INADEQUACY OF THE CURRENT SUITABILITY RULES FOR THE DERIVATIVES MARKET

JENNIFER A. FREDERICK

INTRODUCTION

A senior associate at a New York City law firm specializing in securities litigation met with three new clients in the early part of 1995. John Middlemanager ("Middlemanager"), a marketing executive earning a modest income, was the first new client. Middlemanager informed the attorney that he lost $3500 through option contracts purchased at the recommendation of Robert Richbroker ("Richbroker"), a registered representative employed by Stockseller Investments ("Stockseller"). The marketing executive provided as his
reason for contacting a lawyer the recovery of the $3500 from Rich-broker and Stockseller.

The second new client was Larry Leisure ("Leisure"), a sixty-seven year old retired college professor. In his meeting with the lawyer, Leisure explained how, three months earlier, he entered into a long position in gold futures⁵ at the recommendation of Faith Futuresdealer ("Futuresdealer"), a futures commission merchant⁶ employed by Commodityco, Incorporated ("Commodityco").⁷ Unfortunately, the value of Leisure's futures position decreased by $31,000 because of falling gold prices. Leisure contacted the law firm to inquire about the possibility of receiving compensation for his losses.

Producestuff, Incorporated ("Producestuff"), a medium-sized manufacturing company, was the law firm's third new client. Frank Financeman ("Financeman"), the manager of Producestuff's finance department, met with the senior associate and explained that, in early

---

⁵ A futures contract is an agreement to buy or sell an asset for a specified price at a predetermined time in the future. Hull, supra note 2, at 1. The party who agrees to buy the asset in the future has a long futures position, id. at 2, and the party who agrees to sell the asset has a short futures position. Id. The price at which the asset will be bought or sold is referred to as the "futures price," see id., and the time at which the exchange will take place is the "delivery month." See id. at 21.

For example, if an investor enters into a short position in one soybean contract on the Chicago Board of Trade ("CBOT") with a futures price of $500 (for 5000 bushels) and a delivery month of June, the investor is obligated to sell 5000 bushels of soybeans for $500 in the month of June. In reality, very few futures contracts lead to actual delivery of the underlying asset. Id. at 17. Instead, most investors close out their futures positions prior to delivery by entering into a trade opposite to the original contract. Id. at 17-18.

This Note does not attempt to provide a comprehensive discussion of the futures markets. For a thorough analysis of futures trading, see id. at 17-141.

⁶ A "futures commission merchant" is defined as any "individual, association, partnership, corporation, or trust . . . engaged in soliciting or in accepting orders for the purchase or sale" of futures contracts. 7 U.S.C. § 1a(12) (1994).

⁷ Commodityco is a futures commission merchant and a member of the CBOT. The CBOT is a board of trade designated as a contract market by the Commodity Futures Trading Commission ("CFTC"). See 7 U.S.C. § 2a(ii) (1994) (authorizing the CFTC to designate boards of trade as contract markets for the trading of futures contracts); see also 7 U.S.C. § 1a(15) (1994) (defining "member of a contract market" as "an individual, association, partnership, corporation, or trust owning or holding membership in, or admitted to membership representation on, a contract market or given members' trading privileges thereon"); Hull, supra note 2, at 19 tbl. 2.1 (listing domestic contract markets upon which futures contracts are traded).
1994, Producestuff entered into an interest rate swap agreement with nationally chartered Moneylender Bank, Incorporated ("Moneylender") at Moneylender's recommendation. Unexpected interest rate fluctuations forced Producestuff to make a substantial payment to Moneylender under the swap agreement. Financeman, worried that large future payments might force Producestuff into bankruptcy, asked the attorney if Producestuff could rescind the swap agreement and recover a portion of the previous payment.

Although Middlemanager's, Leisure's, and Producestuff's circumstances are not identical, two common themes characterize their experiences. First, the financial products recommended by Richbroker, Futuresdealer, and Moneylender are all derivative instruments. A "derivative" is generally defined as a contract or security whose value depends on the future price of an underlying asset or assets. The products recommended to Middlemanager, Leisure, and Producestuff do not encompass every type of derivative; they do, however, represent the three most common categories—options, futures, and swaps. Options and futures have long histories in the investment commu-

---

8. A swap agreement is a "private agreement[ ] between two [entities] to exchange cash flows in the future according to a prearranged formula." Hull, supra note 2, at 146. An interest rate swap is a swap agreement under which one party makes payments equal to interest at a predetermined fixed rate on a notional principal and the other party makes payments equal to interest at a floating rate on the same notional amount. Id. The interest rates specified in the swap agreement are often based upon interest rates on treasury securities. See id. at 153. Payments made pursuant to a swap agreement occur at regular intervals, generally every six months. Id. The actual payments made represent the difference between the two promised payments; the notional principal is never exchanged. Id. at 151. The duration of swap agreements is fixed by the parties and usually ranges from two to over 15 years. Id. at 146.

For example, suppose that, on January 6, 1995, parties A and B enter into a swap agreement under which party A agrees to pay party B payments based on a 10% fixed rate of interest and a $1,000,000 notional amount. Party B agrees to pay party A payments based on a floating rate equal to the current three-month treasury bill ("T-bill") rate plus 4%, based on the same notional amount. The parties agree that payments will be made every twelve months. If on July 6 the T-bill rate is 5.50%, party A will pay party B $5,000. The $5,000 represents the difference between party A's promised payment of $100,000 and party B's promised payment of $95,000. See id. at 147-53.

Another popular type of swap is a currency swap. Under a typical currency swap agreement, the parties exchange principal and interest payments on a loan in one currency for principal and interest on a similar loan in a different currency. See id. at 159. In addition to interest rate and currency swaps, there exist several other varieties of swaps. See id. at 165. For a thorough discussion of the rapidly expanding swap market, see id. at 146-68.

nity.\(^{10}\) Swaps, on the other hand, are relatively novel financial instruments.\(^{11}\)

Derivatives, the majority of which a few decades ago were "an obscure backwater of the securities business,"\(^{12}\) are the investment craze of the 1990s. Approximately seventy-five percent of America's largest companies currently utilize derivatives,\(^{13}\) and broker-dealers\(^{14}\) are realizing sizeable profits from structuring derivatives transactions for their customers.\(^{15}\)

Presently, however, both consumers and dealers of derivatives are realizing that these new products are not fail-safe. The Procter & Gamble Company ("P&G"), for example, lost over $150 million (pre-tax) in 1994 as a result of the company's derivatives activity.\(^{16}\) The ramifications of derivatives-related losses suffered by P&G and other

---


11. The market for swaps did not begin to develop until the early 1980s. Clifford W. Smith, Jr. et al., The Evolving Market for Swaps, in The Handbook of Currency and Interest Rate Risk Management 6-1, 6-10 (Robert J. Schwartz & Clifford W. Smith, Jr. eds., 1990); see also Richard W. Jennings et al., Securities Regulation n.48 (7th ed. 1992) (noting that "[a]lthough new, the size of the swaps market dwarfs many other financial markets").


14. For purposes of this Note, brokers and dealers will be referred to collectively as broker-dealers.


end-users are also impacting the dealers. On October 27, 1994, P&G filed suit against Bankers Trust, one of the largest domestic derivatives dealers, seeking to recover losses resulting from a swap agreement recommended by Bankers Trust.\textsuperscript{17} P&G's highly publicized losses, as well as those of other derivatives consumers, have frightened many companies away from all but the safest derivatives.\textsuperscript{18} As a result, dealers' profits from derivatives sales have fallen significantly.\textsuperscript{19}

In addition to all falling within the definition of derivative, the financial instruments recommended by Richbroker, Futuresdealer, and Moneylender may not have been "suitable" for Middlemanager, Leisure, and Producestuff. The general principle of suitability implies that a financial advisor\textsuperscript{20} must refrain from recommending an investment to a customer unless the advisor believes the investment is appropriate in light of the customer's current financial situation and objectives.\textsuperscript{21} Suitability rules transform the concept of suitability into a legal obligation imposed on financial advisors. If governed by such rules, an advisor must obtain information regarding a customer's financial status,\textsuperscript{22} investment objectives,\textsuperscript{23} and capacity to absorb monetary losses\textsuperscript{24} prior to recommending a plan of investment.\textsuperscript{25} The financial advisor violates any applicable suitability rules if he recom-


\textsuperscript{18.} Holland, \textit{Derivatives}, supra note 15, at 76-77.

\textsuperscript{19.} \textit{Id.} at 76. Bankers Trust's income from derivatives activity fell sharply in the second quarter of 1994. \textit{Id.} Also in 1994, J.P. Morgan's derivatives trading revenue fell 17%, Citibank's revenue from derivatives transactions dropped 50% in the first nine months, and Chase Manhattan Corporation suffered a $20 million loss on several derivatives contracts in the fourth quarter. \textit{Id.}

\textsuperscript{20.} For purposes of this Note, the term "financial advisor" includes registered representatives, broker-dealers, futures commission merchants, and banks that engage in investment counseling.


\textsuperscript{22.} This type of information includes the customer's annual income, net worth, tax bracket, and other similar data. \textit{See Pass Trak}, supra note 2, at 246-47.

\textsuperscript{23.} Possible investment objectives include preservation of principal, fixed income, moderate growth, and speculation. \textit{See id.} at 248-49.

\textsuperscript{24.} A customer's capacity to absorb monetary losses depends on factors such as his debt obligations and the number of dependents for whom he provides financial support. \textit{See id.} at 247.

\textsuperscript{25.} \textit{See Greenough}, supra note 21, at 992-93.
mends investments that are inconsistent with the customer's financial profile.26

Suitability rules serve to protect investors from the self-interested actions of unscrupulous financial advisors.27 These rules are often necessary because disclosure of the risks inherent in a recommended investment may not adequately protect a customer with little knowledge of the financial product.28 Suitability rules are important in the context of derivatives because of the risk involved in these complex financial instruments. Even large corporations, generally considered “sophisticated investors,” may not fully understand29 the complicated terms contained in a derivatives contract.30 Furthermore, in the derivatives market, the dealer generally has knowledge and experience far superior to that of the customer.31 Thus, suitability rules should impose a legal duty on derivatives dealers to recommend only suitable derivatives transactions.

Suitability rules, however, should not place overly burdensome duties on financial advisors or expose such advisors to “randomly imposed liability” based on undefined standards.32 Nor should suitability rules eradicate a customer’s freedom to make his own investment decisions.33 Finally, suitability rules should not be a litigation tool in the hands of customers who are simply disappointed with the outcome of their investment decisions.34

The complexity and riskiness of the derivatives recommended to Middlemanager, Leisure, and Producestuff and the superior knowledge possessed by Richbroker, Futuresdealer, and Moneylender indicate that the three clients should recover under suitability rules. Moreover, the inclusion of options, futures, and swaps in the definition of derivative demonstrates that similar suitability rules should govern the hypothetical transactions. Under currently applicable laws, rules, and regulations, however, the injured customers are not entitled

27. Fishman, supra note 21, at 233.
28. Id. at 240. But see Greenough, supra note 21, at 1007 (asserting that disclosure and other customer protection doctrines protect investors from “overreaching” by financial advisors).
29. Actually, corporations do not “understand” anything. The financial professionals employed by corporations cause these entities to be classified as sophisticated.
30. See Peter Blackman, Dealing in Derivatives: Is a “Sophisticated” Investor a “Suitable” One?, N.Y. L.J., May 12, 1994, at 5, 5; see also Greenough, supra note 21, at 992 (recognizing that certain investments may not be suitable for sophisticated investors).
31. Blackman, supra note 30, at 5.
32. Greenough, supra note 21, at 1006.
33. Id. at 1007. Additionally, prohibiting dealers from recommending only suitable derivatives transactions may exclude all but institutional investors and wealthy individuals from the derivatives market. This paternalistic approach is inconsistent with the disclosure-based nature of the federal securities laws.
34. See Fishman, supra note 21, at 248.
to recovery and the legal analysis differs significantly for each of the recommended financial products.

Middlemanager's stock options are considered "securities" under the federal securities laws. Thus, Richbroker's recommendation is governed by the Securities and Exchange Commission ("SEC") and self-regulatory organizations such as the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE"). These SROs have suitability rules that impose a legal duty on registered representatives to ensure that the investments they recommend are suitable for their customers. While registered representatives who violate the SRO suitability rules may be subject to disciplinary sanctions, the rules do not provide a private cause of action for customers injured by unsuitable recommendations.

Injured securities customers can attempt to recover under a section 10(b) cause of action based on unsuitability. A section 10(b) unsuitability claim, however, is difficult to establish. Thus, the existing regulatory framework does not adequately protect customers from unsuitable options transactions.

Leisure’s gold futures are regulated exclusively by the Commodity Futures Trading Commission ("CFTC") pursuant to the Commodity Exchange Act ("CEA"). The CFTC previously considered, but declined to adopt, a suitability rule; thus, no suitability rules currently govern the recommendation of futures contracts. Additionally, the CFTC has stated that the antifraud provisions contained in the CEA do not impose a legal suitability obligation on futures professionals. Thus, the public is not even minimally protected from unsuitable futures transactions.

---

35. The inclusion of options within the definitions of "security" contained in the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act") is discussed infra at notes 67-68 and accompanying text.


37. The jurisdiction of the SEC and SROs is discussed infra at notes 69-71 and accompanying text.

38. The SRO suitability rules are discussed infra at notes 73-101 and accompanying text.

39. The absence of a private cause of action under the NASD and exchange suitability rules is discussed infra at note 103 and accompanying text.

40. The difficulty investors face in establishing section 10(b) liability based solely on unsuitability is discussed infra at notes 109-11 and accompanying text.

41. The jurisdiction of the CFTC is discussed infra at notes 120-21 and accompanying text.

42. The CFTC's decision not to adopt a suitability rule is discussed infra at notes 136-42 and accompanying text.

43. The CFTC's decision not to consider the recommendation of unsuitable investments as a violation of the Commodity Exchange Act ("CEA") antifraud rules is discussed infra at notes 143-47 and accompanying text.
The regulatory framework governing Producestuff's interest rate swap is not as well-defined as that governing options and futures. Producestuff could argue that the interest rate swap is a "security" as defined by federal securities laws. If this argument succeeded, Moneylender would potentially be subject to SRO disciplinary sanctions.\(^{44}\) Swaps, however, do not fit readily into any of the categories of security contained in the federal securities laws.\(^{45}\)

Moneylender, on the other hand, could contend that the interest rate swap is analogous to a futures contract and thus falls within the exclusive jurisdiction of the CFTC.\(^ {46} \) Because the CFTC does not have a suitability rule, Moneylender would have had no duty to determine whether the interest rate swap was suitable for Producestuff if the swap was considered a futures contract. The CFTC, however, exempts the majority of swaps from its regulation.\(^ {47} \)

Finally, because Moneylender is a national bank subject to oversight by the Office of the Comptroller of the Currency ("OCC"), any applicable OCC rules would be relevant in analyzing a claim brought by Producestuff against the bank.\(^ {48} \) The OCC, however, does not impose on banks subject to its jurisdiction a legal duty to recommend only suitable investments.\(^ {49} \)

This Note addresses suitability in the context of derivatives.\(^ {50} \) Part I discusses suitability with respect to options and futures. This part first outlines the existing SRO suitability rules governing options transactions and analyzes the application of these rules. Part I then considers unsuitability as a basis for a section 10(b) cause of action. Finally, part I looks at the CFTC's past and current view on the duty to determine suitability when recommending futures transactions.

Part II considers suitability with respect to swap transactions. This part begins by looking at whether swaps can be classified as either "securities" or "futures," thus subjecting swaps to jurisdiction under the federal securities laws or CFTC rules, respectively. Additionally,

---

44. See infra notes 69-71 and accompanying text. Producestuff would not, however, have a private cause of action against Moneylender. See supra note 103 and accompanying text.

45. Classification of swaps as securities is considered infra at Part II.B.

46. Classification of swaps as futures is considered infra at notes 188-98 and accompanying text.

47. The CFTC's decision not to include most swaps within its jurisdiction is discussed infra at notes 199-205 and accompanying text.

48. Regulation of banks is discussed infra at notes 208-14 and accompanying text.

49. The OCC's decision not to regulate suitability is discussed infra at notes 215-23 and accompanying text.

50. This Note discusses the regulation of derivatives only with respect to the domestic derivatives market. For a thorough discussion of derivatives in the international arena, see Thomas C. Singer, Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action, 18 Fordham Int'l L.J. 1397 (1995).
part II looks at the potentially relevant federal banking regulations governing swap transactions.

Part III of this Note explores the adoption of a suitability rule that would govern all types of derivatives. This part first considers policy arguments for and against adopting such a rule, and then discusses legislation pending in the House of Representatives that would allow for the promulgation and enforcement of a derivatives suitability rule. Finally, part III proposes a model rule and applies it to the situations of Middlemanager, Leisure, and Producestuff. This Note concludes that Congress should enact the pending legislation. It also concludes that the appropriate agencies should promulgate the model rule thereunder.

I. OPTIONS AND FUTURES

Options and futures are similar in many respects. As mentioned previously, both financial products are considered derivatives because their values depend on the future prices of underlying assets. Additionally, both types of contracts involve the future purchase or sale of an asset for a predetermined price. Furthermore, investors use options and futures for similar purposes. Finally, and most importantly for purposes of this Note, both options and futures involve a high level of risk and the potential for substantial losses.

Despite the similarities between options and futures, entirely different regulatory frameworks govern the two types of financial instruments. Options fall within the jurisdiction of the SEC and various SROs, while futures are subject to the exclusive jurisdiction of the CFTC. Thus, options and futures transactions are not subject to the same suitability rules.

This part analyzes the distinct bodies of law that govern the options and futures markets, focusing on suitability. Section A discusses the regulation of options contracts and section B discusses the regulation of futures contracts. This part demonstrates that neither regulatory framework adequately protects customers from unsuitable investments.

51. See supra note 9 and accompanying text.
52. See supra notes 2, 5 and accompanying text. Options and futures differ, however, in that an option holder has the right to buy or sell the underlying asset and a party to a futures contract is obligated to buy or sell the asset. Hull, supra note 2, at 4.
53. Investors use both options and futures for hedging—taking a position in two or more securities that are negatively correlated to reduce risk, speculation—taking a position in the market to increase risk exposure, and arbitrage—locking in a riskless profit by simultaneously entering into transactions in two or more markets. See id. at 6-12.
54. See infra notes 83, 130, 131 and accompanying text.
55. See Jennings, supra note 11, at 15.
56. See infra notes 69-71 and accompanying text.
57. See infra notes 120-21 and accompanying text.
A. Options

This section examines the body of law that governs options transactions similar to Middlemanager's investment. This section first expands the description of the Richbroker/Middlemanager transaction to illustrate pertinent issues. It then outlines the NASD and SRO rules that govern options transactions and demonstrates their application utilizing the Richbroker/Middlemanager transaction. Additionally, this section considers the recommendation of an unsuitable securities investment as a violation of section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and Rule 10b-5 thereunder. This section concludes that the rules governing options trading do not provide customers injured by unsuitable options transactions with an adequate remedy.

1. The Richbroker/Middlemanager Options Transaction

Middlemanager is forty-five years old, married, and along with his wife is responsible for the support of two teenage children. Middlemanager decided to meet with Richbroker to discuss possible strategies for accumulating funds to finance his children's college educations. Middlemanager did not believe his current investments, including $4000 in a bond mutual fund, a $10,000 certificate of deposit maturing in two months, and $23,000 in a savings account, were earning an adequate rate of return.

At the completion of his initial consultation with Richbroker, Middlemanager decided to open a nondiscretionary account with Stock-seller. Middlemanager completed a new account application that requested information regarding his current financial status and investment objectives. On the form, Middlemanager listed his current annual salary as $65,000 and his current net worth as $150,000. In conversation with Richbroker, Middlemanager mentioned that he might receive an inheritance at some point in the future. The amount and anticipated receipt date of the inheritance, however, were not discussed, and Middlemanager did not note the inheritance on his new

60. The hypothetical options transaction is not based on a particular case but was designed to illustrate issues highlighted in various materials.
61. A nondiscretionary account is an account for which the customer, not the registered representative, makes the final investment decisions. Cf. Pass Trak, supra note 2, at 157 (defining a discretionary account as an account for which the customer authorizes the registered representative to make investment decisions).
62. The new account application also contained a clause stating that any controversy arising out of Middlemanager's account must be settled by arbitration in accordance with NASD and NYSE rules. The majority of large brokerage firms include similar pre-dispute arbitration agreements in their new account agreements. New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry: Pre-Dispute Arbitration Agreements, 63 Fordham L. Rev. 1511, 1513 (1995).
Middlemanager did state on the application that his investment objectives were preservation of principal and long-term growth.

At Middlemanager's second meeting with Richbroker, the registered representative suggested that Middlemanager invest in options to increase his rate of return. Middlemanager informed Richbroker that he was unfamiliar with the options market. Richbroker briefly outlined the mechanics of options trading, stressing the ability to accumulate funds quickly through investing in options. Middlemanager, anxious to begin earning money for his children's education, agreed to purchase options for his account.

Richbroker recommended that Middlemanager purchase ten over-the-counter Bigcompany, Incorporated ("Bigcompany") call option contracts. The options had a strike price of seventy-five, an expiration date four months in the future, and a premium of three and one-half. Richbroker informed Middlemanager that he believed the price of Bigcompany stock, then at $74 dollars per share, would rise significantly in the next four months, thus increasing the value of the Bigcompany calls. Middlemanager transferred $3500 from his savings account to his Stockseller account and purchased the Bigcompany calls.

Unfortunately, the direction of the price of Bigcompany stock did not rise in accordance with Richbroker's predictions and instead fell to $65 dollars per share over the next four months. Thus, when Middlemanager's call options expired, they were worthless. Upset about his $3500 loss, Middlemanager contacted a lawyer.

2. Jurisdiction and Applicable Suitability Rules

The Securities Act of 1933 ("1933 Act") and the 1934 Act, as amended, include option contracts in their definitions of "security."
Moreover, courts have long held that options are securities under the federal securities laws. The SEC has regulatory jurisdiction over all securities transactions initiated by broker-dealers. Accordingly, broker-dealers recommending or executing transactions in options must comply with applicable SEC rules. Additionally, a national securities exchange has jurisdiction over securities transactions executed on that exchange, and the NASD imposes rules governing over-the-counter trading in securities. Thus, in addition to SEC rules, a broker-dealer recommending options to a customer is subject to exchange or NASD rules, depending on whether the options are traded on an exchange or over-the-counter.

The SEC does not currently have a suitability rule. Both the NASD and the major national securities exchanges, however, have

---

interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.


The 1934 Act definition of "security" is as follows:

The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any interest or instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.


suitability rules. The following subsections provide a description of these rules.

a. **NASD Suitability Rules**

The NASD has both a general suitability rule applicable to all recommendations of over-the-counter securities transactions ("NASD general suitability rule"),\(^7\) and a specific suitability rule governing only recommendations of over-the-counter options transactions ("NASD options suitability rule").\(^7\) The NASD general suitability rule allows a registered representative to recommend a securities transaction to a customer only if he has a reasonable belief that the transaction is suitable for the customer.\(^7\) Additionally, the NASD

---

73. The full text of the NASD general suitability rule is as follows:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(i) the customer's financial status;

(ii) the customer's tax status;

(iii) the customer's investment objectives; and

(iv) such other information used or considered to be reasonable and by such member or registered representative in making recommendations to the customer.


Additionally, the NASD recently issued an interpretation of its general suitability rule applicable to recommendations made to institutional customers. NASD Notice to Members 95-21 (April 1995); see also Richards & Greenspan, supra note 17, at 4 (describing in detail the NASD's interpretation of its general suitability rule).

74. The full text of the NASD options suitability rule is as follows:

(A) No member or person associated with a member shall recommend to any customer any transaction for the purchase or sale (writing) of an option contract unless such member or person associated therewith has reasonable grounds to believe upon the basis of information furnished by such customer after reasonable inquiry by the member or person associated therewith concerning the customer's investment objectives, financial situation and needs, and any other information known by such member or associated person, that the recommended transaction is not unsuitable for such customer.

(B) No member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.


75. NASD Manual (CCH) ¶ 2152, at 2050 (1995). The NASD suitability rule applies only to transactions that are recommended by a member broker-dealer. Eileen
general suitability rule mandates that a registered representative make reasonable efforts to obtain from the customer information concerning (1) the customer’s financial status, (2) the customer’s tax status, (3) the customer’s investment objectives, and (4) any other relevant information. The registered representative must then base his determination of suitability on this information.

The NASD options suitability rule imposes requirements additional to those imposed by the general suitability rule. Under the NASD options suitability rule, a registered representative recommending an options transaction must, in addition to suggesting only suitable investments, have a reasonable belief that (1) the customer has the knowledge and financial experience sufficient to understand the risks of the recommended options transaction, and (2) the customer is financially able to bear the risks of the transaction.

b. Exchange Suitability Rules

The major national securities exchanges have suitability rules that are similar or identical to the NASD general and options suitability rules. For example, NYSE Rule 405 requires persons associated with NYSE member broker-dealers ("associated persons") to "use due diligence to learn the essential facts" relative to the customer when recommending transactions in securities. Although Rule 405 does not expressly require associated persons to recommend only suit-

J. Berkman, Suitability in Commodity Futures Trading, 20 Rev. Sec. & Commodities Reg. 1, 2 n.5 (1987). Thus, broker-dealers are not obligated to determine the suitability of unsolicited purchases, sales, or exchanges of securities.

76. NASD Manual (CCH) ¶ 2152, at 2050 (1995). This paragraph, which imposes on registered representatives an affirmative duty to obtain information from customers, was made effective in January 1991. Id. Prior to this time, the issue of whether broker-dealers had such an affirmative duty was unsettled. Thomas A. Russo & Mar- lisa Vinciguerra, Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development, 69 Tex. L. Rev. 1431, 1503 (1991).


78. NASD Manual (CCH) ¶ 2183, at 2168 (1995). Section (A) of the options suitability rule imposes a duty to recommend only suitable options transactions that is virtually identical to the general suitability rule. Id. Section (B) adds the additional requirements for recommendations of options transactions. Id.

79. This Note discusses only the NYSE suitability rules because a large percentage of securities transactions occur on the NYSE. Jennings, supra note 11, at 65. The suitability rules of other major national securities exchanges closely parallel the NYSE rules. See American Stock Exchange: Constitution and Rules (CCH) ¶ 9431, at 2647 (1988) (American Stock Exchange ("AMEX") general suitability rule); Id. ¶ 9723, at 3028 (1989) (AMEX options suitability rule); Chicago Board Options Exchange: Constitution and Rules (CCH) ¶ 2309, at 2135 (1982) (CBOE suitability rule).

80. NYSE Rule 405 states in pertinent part: "Every member organization is required . . . to . . . [u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization." 2 NYSE Guide (CCH) ¶ 2405, at 3696 (1994).
able transactions to their customers, courts and commentators agree that the rule imposes such a duty. Additionally, NYSE Rule 723, similar to the NASD options suitability rule, requires an associated person recommending the purchase or sale of an option contract to have a reasonable belief that the customer possesses the requisite knowledge to understand, and the ability to bear the risks of, the options transaction.

The preceding discussion of NASD and exchange suitability rules demonstrates that the suitability rules applicable to the recommendation of options transactions are well-defined. An investment professional recommending to a customer the purchase or sale of an option contract must first obtain information regarding the customer's financial situation and objectives. He must then, based on the information obtained from the customer, either (1) assure himself that the option contract is suitable for the customer or (2) abstain from making the recommendation. Additionally, the investment professional must have a reasonable belief that the customer possesses the ability to understand, and the financial resources to absorb, the risks of the transaction.

3. Applying the NASD and Exchange Suitability Rules

The NASD and exchange suitability rules provide basic principles with which investment professionals must comply in recommending to customers the purchase or sale of option contracts. The SEC has expanded these principles in administrative hearings. This subsection illustrates the application of the NASD and exchange suitability rules, utilizing the Richbroker/Middlemanager transaction to highlight pertinent issues.

Compliance with the NASD and exchange suitability rules in recommending an options transaction involves analysis of several factors. The customer's individual financial status is of primary importance. The SEC has stated repeatedly that options are risky, speculative financial instruments that expose investors to the potential for significant losses. Thus, options trading is not suitable for customers with

81. Baker & Lawrence, supra note 26, at 286.
82. The full text of NYSE Rule 723 is as follows:

No member organization or member, allied member or employee of such member organization shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

a limited net worth or low income.\textsuperscript{84} Nor should an investment professional recommend options to a retired customer with a fixed income,\textsuperscript{85} or a customer who depends on the funds generated from his investments for daily living expenses.\textsuperscript{86}

In response to an accusation of making an unsuitable recommendation, Richbroker may argue that Middlemanager's $65,000 annual salary and $150,000 net worth indicate that Middlemanager had sufficient financial resources to engage in options trading. Additionally, Richbroker may raise Middlemanager's expected inheritance in his defense. Middlemanager's earnings and net worth, and the brief discussion of the speculative inheritance, however, do not excuse Richbroker's unsuitable recommendation. First, Richbroker took no steps to discover the amount of the inheritance or when it was expected to arrive. Furthermore, a client's wealth does not relieve an investment professional of his duty to determine suitability.\textsuperscript{87} Other factors may render options trading unsuitable even for a customer with substantial financial resources.

A customer's individual circumstances apart from wealth must also be considered when determining the suitability of options trading for that customer. A customer's age, marital status, and responsibility for dependents are relevant. An investment professional is likely to violate suitability rules by suggesting the purchase or sale of options to an elderly customer, as that customer does not have significant future earning power.\textsuperscript{88} A customer's relative youth, however, does not ensure that options are suitable for that customer. A customer who, like Middlemanager, is responsible for the financial support of others may not have the discretionary income necessary to withstand the potential losses inherent in options trading. Additionally, options are usually inappropriate for a widow or widower who is dependent solely on his or her income.\textsuperscript{89}

In addition to a customer's financial and personal background, an investment professional must address the customer's investment objectives in determining suitability. Middlemanager noted on his new account application that his investment objectives included preservation of principle and long-term growth. These investment objectives are not consistent with the purchase of speculative call options.\textsuperscript{90}

\textsuperscript{84} See Keel, 53 SEC Dock. at 461.
\textsuperscript{86} See Erdos, 29 SEC Dock. at 181.
\textsuperscript{88} See id.
\textsuperscript{89} See id.
Even a customer interested in short-term growth is not necessarily suitable for options trading. An options transaction is appropriate only for a customer who seeks aggressive growth and speculation. Richbroker may argue that his recommendation was suitable because Middlemanager was anxious to begin earning money for his children's education and agreed to purchase options. Richbroker, however, had a duty to make recommendations in accordance with Middlemanager's financial situation and objectives, notwithstanding Middlemanager's statements.

In recommending an options transaction, an investment professional also must have a reasonable belief that the customer fully understands the nature and risks of the transaction. This reasonable belief is necessary even if the customer consents or agrees that the recommendation is appropriate. Although disclosure of the risks of options trading is required, disclosure alone is insufficient. An investment professional must look at a customer's prior investment experience to determine if the customer actually understands options trading. A customer like Middlemanager, whose portfolio consists only of conservative investments such as government bonds and blue chip stocks, probably does not comprehend fully the risks inherent in options trading. Richbroker's brief description of the mechanics of options trading did not assure that Middlemanager had the requisite understanding. Even a customer with significant experience in buying and selling speculative stocks and high yield bonds might not understand the particulars of option contracts.

An investment professional cannot avoid suitability obligations by stating that a customer failed to provide all relevant information. The suitability rules impose an affirmative duty to make reasonable efforts to acquire information regarding a customer's financial sta-

91. Keel, 53 SEC Dock. at 460.
95. See Keel, 53 SEC Dock. at 461.
99. For example, Middlemanager's failure to include the details of his expected inheritance does not excuse Richbroker's unsuitable recommendation.
If an investment professional is unable to obtain all the necessary information, he cannot make recommendations based merely on assumptions regarding the customer's financial situation and objectives. Nor can a registered representative excuse the recommendation of unsuitable securities by claiming he did not realize the recommendation was unsuitable. Ignorance of his business does not relieve an investment professional of suitability obligations.\textsuperscript{100}

The preceding discussion demonstrates that the NASD would probably impose disciplinary sanctions on Richbroker for the recommendation of an unsuitable investment.\textsuperscript{102} Middlemanager, however, will not be able to recover from Richbroker or Stockseller the $3500 he lost as a result of Richbroker's unsuitable recommendation. Courts have consistently held that there is no implied private cause of action for the violation of NASD or exchange rules.\textsuperscript{103} Thus, although Richbroker's actions obviously did not comport with the requirement of fair dealing implicit in the broker-customer relationship,\textsuperscript{104} Middlemanager is left without a remedy.

4. Section 10(b) and Suitability

Middlemanager may pursue alternative avenues to recover the $3500 lost as a result of the Bigcompany call options transaction. On occasion, courts have held that the recommendation of unsuitable securities constitutes a violation of section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.\textsuperscript{105} In order to establish a section 10(b) claim against an investment professional for injuries resulting from an unsuitable options transaction, a customer must prove the following elements: (1) that the recommended options were unsuitable for the customer based on the customer's financial situation and objectives; (2) that the investment professional knew or had reason to know that the options were unsuitable; (3) that the investment professional recommended the options transaction despite knowledge of

\textsuperscript{100} See supra note 76 and accompanying text; see also In re Greenberg, 40 SEC 133, 137-38 (July 21, 1960) (finding that a registered representative cannot rely solely on information volunteered by the customer in determining suitability).


\textsuperscript{102} NASD disciplinary sanctions for the recommendation of unsuitable securities include fines, suspension from the securities business, and requirement of requalification by examination. National Association of Securities Dealers, Inc., NASD Sanction Guidelines 43 (1993).

\textsuperscript{103} See, e.g., Jablon v. Dean Witter & Co., 614 F.2d 677, 680 (9th Cir. 1980) (finding absence of congressional intent to create a private cause of action arising solely out of rules violations).


suitability; (4) scienter; and (5) justifiable detrimental reliance.\textsuperscript{106} Some courts find scienter if the customer demonstrates that the investment professional misrepresented or failed to disclose the unsuitability of the options transaction.\textsuperscript{107} Other courts, however, require an intent to defraud or a reckless disregard for the customer's interests to establish the scienter necessary to prevail on a section 10(b) unsuitability claim.\textsuperscript{108}

Several difficulties arise in attempting to establish liability for unsuitable recommendations under section 10(b). First, a customer grounding his section 10(b) claim in unsuitability alone may have difficulty satisfying the scienter requirement if this element is premised on an intent to defraud or a reckless disregard for the customer's interests.\textsuperscript{109} Additionally, an investment professional can escape liability under section 10(b) by demonstrating that, based on the information provided by the customer, he did not know or have reason to know that the recommendations were unsuitable. The section 10(b) knowledge requirement does not impose an affirmative duty to obtain information sufficient to make suitable recommendations. Finally, an investment professional may be able to disprove the reliance element simply by showing that he disclosed the risks and possible unsuitability of the recommendation to the customer, even if he did not take steps to insure that the customer fully understood this information.\textsuperscript{110} Thus, it is extremely difficult for customers injured by unsuitable recommendations to succeed under section 10(b).\textsuperscript{111}

**B. Futures**

This section analyzes the rules that govern futures positions similar to Leisure's long position in gold futures. This section first expands the description of the Futuresdealer/Leisure transaction to illustrate suitability issues that arise in futures trading. It then discusses the CFTC's exclusive jurisdiction over futures contracts and describes the

\textsuperscript{106} See Brown, 991 F.2d at 1031.

\textsuperscript{107} See, e.g., id. ("Scienter may be inferred by finding that the defendant knew or reasonably believed that the securities were unsuited to the investor's needs, misrepresented or failed to disclose the unsuitability of the securities, and proceeded to recommend . . . the securities anyway.").

\textsuperscript{108} See, e.g., O'Connor, 965 F.2d at 898-99 ("[F]or unsuitability a plaintiff must show the broker [recommended] the securities with an intent to defraud or with reckless disregard for the investor's interests.").

\textsuperscript{109} See id. at 898-900. In O'Connor, the court found no scienter where the defendant broker-dealer testified that he believed the recommended investments were only "modestly risky" and personally investigated the recommended investments. Id. at 899-900. The fact that the customer in O'Connor was notified of the activity in her account also weighed against a finding of scienter. Id. at 900.

\textsuperscript{110} See Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1032 (2d Cir. 1993).

\textsuperscript{111} See Russo & Vinciguerra, supra note 76, at 1507 ("[P]roving a [Rule 10b-5] violation . . . requires a good deal more than proof of failure to comply with [NASD and exchange] suitability requirements . . . .").
CFTC's past and current position on suitability. This section demonstrates that CFTC rules do not protect customers from unsuitable futures transactions.

1. The Futuresdealer/Leisure Futures Transaction\textsuperscript{112}

Leisure retired in 1993 from his position as a biology professor at the University of Anystate. Leisure receives a pension of $90,000 per year and a monthly payment of $2250 from a fixed annuity. Hoping to purchase a beachfront home in Florida, Leisure contacted Futuresdealer to discuss growth investments.\textsuperscript{113}

At Leisure's initial meeting with Futuresdealer, the futures commission merchant recommended that Leisure invest in futures contracts to accumulate funds for his Florida dream house. Although Leisure's prior investment experience consisted primarily of buying and selling blue chip common stocks, he had previously entered into futures contracts on two occasions. Eager to earn a high rate of return on his money and build his Florida estate as soon as possible, Leisure decided to follow Futuresdealer's advice and invest in futures contracts. Leisure indicated to Futuresdealer that he had $125,000 of risk capital available to trade futures.\textsuperscript{114} He also signed a risk disclosure statement provided to him by Futuresdealer which discussed the risks involved in futures trading.\textsuperscript{115}

Futuresdealer recommended that Leisure establish a long position in ten gold futures contracts with a futures price of $381 per ounce and a delivery month four months in the future.\textsuperscript{116} Because each contract is for the purchase and sale of 100 ounces of gold,\textsuperscript{117} the total value of the position was $381,000. Leisure deposited the required initial margin amount of $100,000\textsuperscript{118} and established the position. Unfortu-

\textsuperscript{112} The hypothetical futures transaction is not based on a particular case but was designed to illustrate issues highlighted in various materials.

\textsuperscript{113} Growth investments generally provide a greater return, and a greater risk, than the overall market. Pass Trak, supra note 2, at 417.

\textsuperscript{114} Because Leisure already had an account with Commodityco, he did not fill out a new account application. Futuresdealer did not look at the copy of Leisure's new account application contained in his file nor did she take any steps to obtain information about Leisure's current financial situation.

\textsuperscript{115} Futures professionals are required under 17 C.F.R. § 1.55 (1995) to provide a risk disclosure statement to customers establishing futures positions.

\textsuperscript{116} For a discussion of the terminology used in futures trading, see supra note 5.

\textsuperscript{117} See Ross, supra note 2, at 709.

\textsuperscript{118} The initial margin is the amount an investor is required to deposit in an account (“margin account”) upon establishing a futures position. Hull, supra note 2, at 23. At the end of each trading day, the margin account is adjusted to reflect the investor's gain or loss for that trading day. \textit{Id}. This procedure is referred to as “marking to market.” \textit{Id}. If there is a gain, the margin account is increased and the investor is entitled to withdraw any amount in excess of the initial margin. \textit{Id}. at 23-24. If, however, as a result of losses, the margin account falls below a certain level (“maintenance margin”), the investor receives a margin call and must deposit funds to return the account to the initial margin. \textit{Id}. 

nately, the price of gold fell to $350 per ounce over the next two months. This price decrease caused the balance in Leisure's account to fall below the maintenance margin of $75,000. Thus, Leisure received a margin call for $25,000 to return his account to the initial margin level. Instead of paying the $25,000, Leisure contacted a lawyer.

2. The CFTC and Suitability

All transactions in futures contracts are subject to the exclusive jurisdiction of the CFTC. Thus, a futures professional recommending futures contracts to a customer must comply with all applicable CFTC rules and regulations. Although the CFTC does not currently have a suitability rule, it has addressed suitability in the context of futures trading. This subsection discusses a suitability rule proposed and dis-

119. Because the price of gold dropped $31 per ounce from $381 to $350 per ounce, the value of Leisure's position fell $31,000 (31 x 10 x 100). This loss decreased his margin account from $100,000 to $69,000. See Hull, supra note 2, at 23.
120. The CFTC was established under § 2(a)(2) of the CEA. 7 U.S.C. § 4a(a)(1) (1994). Under CEA § 2(a)(1)(B), the CFTC has exclusive jurisdiction over all futures contracts, and options on futures contracts, traded or executed on a “contract market” designated as such by the CFTC under § 2 of the CEA. 7 U.S.C. § 2a(ii) (1994); 7 U.S.C. § 7 (1994). Moreover, under § 4(a) and § 4h of the CEA, it is unlawful to transact in, or conduct a business for the purposes of transacting in, futures contracts or options on futures contracts other than on a designated contract market. 7 U.S.C. § 6(a) (1994); 7 U.S.C. § 6h (1994); see Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 539 (7th Cir. 1989); Messer v. E.F. Hutton & Co., 847 F.2d 673, 674-75 (11th Cir. 1988).


Under § 4c of the CEA, the CFTC also has exclusive jurisdiction over all transactions in options on commodities. 7 U.S.C. § 6c(b) (1994). The CFTC prohibits entirely the trading of options on agricultural commodities. 17 C.F.R. § 32.2 (1995).

The CEA provides certain limited exceptions to CFTC jurisdiction. First, forward contracts, generally defined as agreements for the sale of a “cash commodity for deferred shipment or delivery,” are exempt from CFTC regulation. 7 U.S.C. § 1a(11) (1994). Forward contracts are similar to futures contracts, but, unlike futures, are privately negotiated between parties who do business in the underlying commodity and have the intent and capacity to make or take delivery of the commodity. See Bybee v. Krommenhoek, 945 F.2d 509, 514 (9th Cir. 1991); 55 Fed. Reg. 39,188, 39,190-91 (1990). Second, under § 4c of the CEA, “dealer options” are exempt from CFTC regulation. 7 U.S.C. § 6c(d) (1994). A dealer option is a commodity option offered to a “producer, processor, or commercial user of, or a merchant handling” the commodity underlying the option that enters into the option contract for purposes related to its business. 17 C.F.R. § 32.4 (1995). Finally, the Treasury Amendment contained in § 2(ii) of the CEA removes “individually-negotiated foreign currency option and futures transactions between sophisticated, large-scale foreign currency traders” from CFTC jurisdiction. Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 978 (4th Cir. 1993).

121. The CFTC’s rulemaking power is granted under §§ 2(a) and 8a of the CEA. 7 U.S.C. § 4a(j) (1994); 7 U.S.C. § 12a(5) (1994).
carded by the CFTC. Additionally, this subsection analyzes unsuitability as a cause of action under the antifraud provisions contained in the CEA.

a. The CFTC's Proposed Suitability Rule

In the late 1970s, the CFTC proposed a rule that would have imposed on futures professionals the legal duty to recommend only suitable investments.\textsuperscript{122} Proposed Rule 166.2 would have required futures professionals, prior to recommending a futures transaction, to obtain the essential facts regarding the customer's financial condition and trading objectives.\textsuperscript{123} These essential facts included, but were not limited to, the customer's net worth, income, number of dependents,

---

122. Proposed CFTC Rule 166.2 stated in pertinent part:

Suitability of recommendations and discretionary trades.

(a) No Commission registrant or representative thereof may, directly or indirectly, make any recommendation to any customer concerning the purchase, sale or continued holding of any commodity interest . . . unless the Commission registrant or representative thereof—

(1) Within a reasonable period of time before the recommendation . . .

(i) Obtained from the customer the essential facts about the customer's financial condition and trading objectives, and

(ii) Verified with the customer the accuracy of that information if previously obtained and

(2) At the time of the recommendation or transaction, had reason to believe that the recommendation . . . was suitable for the customer in light of

(i) The information obtained from the customer and otherwise known about the customer by the Commission registrant or representative thereof, and

(ii) The risk of loss involved therein.

(b) For purposes of this section, the term "recommendation" means any advice, suggestion or other statement that is intended, or can reasonably be expected, to influence a customer to purchase, sell or hold a commodity interest, but does not include any statement that merely describes in an objective fashion the commodity interest, the manner in which it is traded or the service of the Commission registrant or representative thereof.

(c) This section does not apply to recommendations furnished solely through—

(1) Uniform publications distributed to subscribers thereto,

(2) Books,

(3) Television or radio communications, or

(4) Seminar or lecture presentations.


If adopted, Rule 166.2 would have provided customers with a private cause of action for violations of the rule. \textit{See} 7 \textit{U.S.C.} \textsection 25(a) (1994).

123. 42 Fed. Reg. 44,742, 44,750 (1977). The CFTC noted these factors in its discussion surrounding Rule 166.2. The Commission further noted that, because suitability is fact specific, establishment of fixed standards would be inappropriate. \textit{See id.} at 44,744.
financial obligations, and other investments. If a futures professional could not gather the necessary information, proposed Rule 166.2 would have prohibited him from making a recommendation.

Additionally, proposed Rule 166.2 would have required that futures professionals have a "reason to believe that [a] recommendation . . . was suitable for [a] customer" prior to making the recommendation. Under Rule 166.2, suitability would have depended on whether the risk of loss involved in the recommended futures transaction was "(a) one that the customer could safely assume in light of his financial condition and (b) consistent with the customer's trading objectives." A futures professional subject to Rule 166.2 would have had to reasonably believe that both futures trading in general, and the particular recommended transaction, were suitable for the customer.

In proposing Rule 166.2, the CFTC stressed the necessity for a suitability rule applicable to futures transactions. The CFTC stated that most customers are unaware of the substantial risk of loss inherent in futures trading. The CFTC further reasoned that, because futures contracts can be purchased on relatively small margins and because market prices of such contracts often fluctuate rapidly, customers purchasing and selling futures contracts can lose significantly more than their original investment. Additionally, the CFTC, in addressing the necessity of a suitability rule, noted that disclosure, while necessary, is not sufficient to protect customers. The CFTC believed that disclosure alone did not protect customers from the high pressure sales tactics often engaged in by futures professionals. Moreover, the CFTC stated that, because futures professionals have the skills and background necessary to analyze the risks of futures trading, the duty to assess such risks should lie with these profession-

124. *Id.* While possession of other speculative investments might indicate a customer's understanding of futures trading, the CFTC in proposing Rule 166.2 indicated that such investments render the recommendation of futures transactions unsuitable. *Id.* The CFTC reasoned that a customer already committed to other forms of speculation should not be exposed to further risk. *Id.*

125. *Id.* at 44,743. A futures professional could usually, however, rely on the customer's statements without having to make a further inquiry to verify the information. *Id.* at 44,744. Nonetheless, further inquiry would be necessary if he had good cause to believe that the information was materially inaccurate. *Id.*

126. *Id.* at 44,750.

127. *Id.* at 44,743. The CFTC specifically stated that futures trading may be unsuitable for customers seeking production of income and preservation of capital. *Id.* at 44,744.

128. *Id.*

129. *Id.* at 44,743-44.

130. *Id.* at 44,743.

131. *Id.* at 44,743-44.

132. *Id.* at 44,744.

133. *Id.*
Futures professionals should not transfer the risks of futures trading to the customer.\textsuperscript{134} Notwithstanding its reasoning in favor of adopting a suitability rule governing the recommendation of futures transactions, the CFTC declined to adopt proposed Rule 166.2.\textsuperscript{136} The CFTC based its decision not to adopt the rule on the CFTC's inability to formulate "meaningful standards of universal application."\textsuperscript{137} Apparently, the CFTC was addressing the difficulty of determining standards regarding (1) the degree of risk involved in various futures transactions and (2) the particular customer objectives for which futures trading would be inappropriate.\textsuperscript{138} This reasoning, however, is contrary to the CFTC's earlier statement that the fact specific nature of suitability argues against setting fixed standards.\textsuperscript{139} Instead of a suitability rule, the CFTC adopted a mandatory disclosure rule requiring futures professionals, prior to making a recommendation, to furnish customers with a written statement describing the risks of futures trading.\textsuperscript{140} This written statement suggests that customers should consider whether futures trading is suitable for their situation.\textsuperscript{141} After the statement is provided to the customer, the futures professional is relieved of any suitability obligations and the duty to determine suitability is transferred to the customer.\textsuperscript{142} 

b. \textit{Unsuitability as a Violation of the CEA Antifraud Provisions}

At one time, the recommendation of an unsuitable futures transaction was thought to violate the antifraud provisions contained in section 4b of the CEA.\textsuperscript{143} Prior to the CFTC's decision in \textit{Phacelli v. ContiCommodity Services, Inc.},\textsuperscript{144} several CFTC Administrative Law Judges deciding suitability cases found liability for unsuitable recom-

\begin{footnotes}
134. \textit{Id.}
135. \textit{Id.}
137. \textit{Id.} at 31,888.
139. \textit{See supra} note 123.
\end{footnotes}


SUITABILITY AND DERIVATIVES

In Phacelli, however, the CFTC expressly stated that a futures professional does not violate section 4b "merely because he fails to determine whether a customer is suitable for [futures] trading." Subsequent CFTC and court decisions have consistently followed Phacelli in holding that no legal duty to recommend only suitable futures transactions arises under section 4b of the CEA. The preceding discussion demonstrates that the CFTC does not currently have an explicit suitability rule, and that no such rule is implicit in section 4b of the CEA. Thus, Leisure is left without a remedy for his injuries resulting from Futuresdealer's careless recommendation.

II. SWAPS

The initial inquiry in addressing suitability in the context of options and futures is whether there exist suitability rules applicable to these types of derivatives. The applicable body of law to look to in answering this question is well-settled. For swaps, however, a court or administrative agency must first determine what law to apply in analyzing the legality of swap transactions.

This part looks at what regulatory framework should govern swaps similar to Producestuff's interest rate swap. Section A provides a detailed description of the Moneylender/Producestuff transaction to emphasize legal issues involved in swap transactions. Section B analyzes

---


146. Phacelli v. ContiCommodity Servs., Inc., [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250, at 32,674 (CFTC 1986). The CFTC in Phaceli, however, did provide two limited exceptions to the rule that § 4b liability cannot be imposed for suitability violations. First, the CFTC stated that § 4b liability will attach when a futures professional's recommendation of unsuitable futures contracts amounts to "overreaching," as when such professional takes advantage of an "exceptionally gullible" or "dim-witted" customer. Id. Second, a futures professional will be found liable under § 4b if he affirmatively misrepresents the suitability of a recommendation and the customer relies on the misrepresentation. Id. at 32,674-75.


A customer seeking to recover against a futures professional for injuries resulting from unsuitable recommendations may attempt to argue that such futures professional breached his common law fiduciary duty owed to the customer. Van Smith, supra note 142, at 626-27. Most courts, however, hold that brokers do not owe a duty to determine suitability unless the customer's account is discretionary. See Wasnick v. Refco, Inc., 911 F.2d 345, 349-50 (9th Cir. 1990); Sherry v. Diercks, 628 P.2d 1336, 1341 (Wash. Ct. App. 1981); see also Lefkowitz v. Smith Barney, Harris Upham & Co., 804 F.2d 154, 155 (1st Cir. 1986) (stating that common law fiduciary duty does not arise from simple stockbroker-customer relationship).
swaps as securities under the federal securities laws and Section C considers swaps as futures contracts subject to CFTC jurisdiction. Section D examines federal regulation of swaps recommended by banks.

### A. The Moneylender/Producestuff Swap Transaction

Producestuff is a privately held company incorporated in Denver, Colorado. The company has a current net worth of approximately $2,500,000 and an average annual after-tax income of $750,000. Producestuff finances the majority of its operations with debt. A finance department staffed by Financeman, the manager, and twenty employees determines Producestuff’s borrowing needs. Financeman possesses an advanced business degree and Producestuff hired him specifically for his expertise in corporate finance. The finance department employees, however, have no specialized financial training.

Moneylender is a nationally chartered bank and handles Producestuff’s borrowing needs. This banking relationship dates back to Producestuff’s founding five years ago. In addition to making loans to Producestuff, Moneylender advises the company regarding how best to finance its operations. Accordingly, Moneylender possesses significant information regarding Producestuff’s cash flow, investments, strategic plans, and risk tolerance.

Producestuff traditionally financed its operations through short-term loans from Moneylender with floating interest rates based on the three-month commercial paper rate. Last month, however, after Producestuff reported an annual earnings increase of twenty-five percent for the previous year, a large investment bank approached the company’s finance department. Based on its confidence in Producestuff’s ability to continually increase earnings, the investment bank offered to underwrite a bond issue for the company. Producestuff, interested in locking in a fixed interest rate for its debt, agreed to proceed with the bond issue. Producestuff pays interest on the bonds semi-annually at a rate of six and one-half percent.

---

148. The hypothetical swap transaction and the circumstances surrounding it are based on various readings consulted by the author.

149. Moneylender does not offer investment banking services.

150. Commercial paper consists of short-term notes with varying maturities issued by large companies with good credit ratings. Ross, supra note 2, at 766-67. Producestuff did not itself issue commercial paper. Instead, it entered into traditional loan agreements with Moneylender. Under these agreements, Producestuff would pay interest monthly, but the rate of interest would be adjusted every three months according to the three-month commercial paper rate. The three-month commercial paper rate generally lies between the three-month and one-year treasury bill rates.

151. Because Producestuff’s previous earnings were negative or very low, the company had not been able to find an investment bank that would underwrite a bond issue for it.
Producestuff sells its products through various distributors nationwide. These distributors purchase the products with revolving credit issued by Producestuff. The interest paid on the revolving credit is based on the three-month commercial paper rate and the credit agreements can be renegotiated every two years. Producestuff's obligations under the bond issue exposed the company to the risk of commercial paper rates falling to a level well below six and one-half percent, resulting in incoming payments from distributors being significantly lower than outgoing payments to the bondholders.

Seeking to hedge this risk, Financeman and a special team of five finance department employees approached Moneylender for advice. Moneylender suggested an interest rate swap. Financeman and the special team agreed that an interest rate swap agreement appeared appropriate. Financeman, however, stressed certain objectives that Producestuff had in entering into a swap agreement with Moneylender. First, Producestuff wanted to make payments based on a floating rate of interest that closely paralleled the three-month commercial paper rate. Additionally, Producestuff desired to make payments at relatively frequent intervals to avoid exposure to interest rate fluctuations. Moneylender stated that, as an expert in designing "proprietary" swaps, it could tailor an interest rate swap to meet Producestuff's particular needs.

The interest rate swap recommended by Moneylender to Producestuff is embodied in the following contract ("Swap Agreement"): 

SWAP AGREEMENT

1. Commencing February 1, 1994, Moneylender, Incorporated agrees to make payments to Producestuff, Incorporated based on a fixed interest rate of six and one-half percent (6.50%).

2. Producestuff agrees to make payments to Moneylender based on a floating rate of interest equal to:

\[ \left( \text{thirty-year T-bond rate} - \text{three-month T-bill rate} \right) \times 2.5 + 1.7 \]

152. The Producestuff finance department structured the revolving credit agreements to correspond with the loan agreements with Moneylender. If the three-month commercial paper rate increased, the payments received from distributors would increase along with the payments made to Moneylender.

153. For a description of swaps, see supra note 8.

154. This payment arrangement would correspond with the payments received from distributors.


156. A Treasury bond, or "T-bond," is a long-term (10 to 30 years), fixed-interest federal government debt security. Pass Trak, supra note 2, at 63.

157. A Treasury bill, or "T-bill," is a short-term (90 days to one year) federal government security issued at a discount from par. Id. at 62.
3. The payments described in paragraphs one and two will be made on a ten million dollar ($10,000,000) notional principal.

4. The payments described in paragraphs one and two will be made at six-month intervals.

5. The duration of this Swap Agreement is fifteen years.

6. The creditworthiness of Producestuff and Moneylender is a material consideration of the parties in entering into this Swap Agreement.

7. This Swap Agreement requires Producestuff to deposit one hundred thousand dollars ($100,000) in cash as collateral.

On August 1, 1994, the T-bond rate was 7.56% and the T-bill rate was 5.72%. Thus, Moneylender satisfied its obligations under the Swap Agreement with a $10,000 payment to Producestuff. Between August 1, 1994 and February 1, 1995, however, the disparity between T-bill and T-bond rates widened significantly. On February 1, the T-bond rate was 8.60% and the T-bill rate was 5.00%. Thus, under the Swap Agreement, Producestuff paid $210,000 to Moneylender. The size of this payment concerned Producestuff. The commercial paper rate had fallen to 5.25% and thus interest payments from distributors were lower than they had been previously. Financeman and the special team could not understand why Producestuff’s payments under the swap agreement had increased dramatically while payments from distributors had fallen.

The finance department notified Moneylender of its disappointment with the swap transaction. Moneylender assured Producestuff that the large disparity between T-bond and T-bill rates was unusual and would probably decrease shortly. On July 15, 1995, however, the rates were even further apart, with the T-bond rate at 8.80% and the T-bill rate at 4.90%. Producestuff, realizing the magnitude of the payment it would have to make on August 1 if the difference between T-bond and T-bill rates continued to increase, notified Moneylender of its intention not to make the August 1 payment. Producestuff then contacted a lawyer.

B. Swaps as Securities

A party arguing that swaps are securities would probably contend that swaps are either “investment contracts” or “notes” under the 1933 and 1934 Acts. Well-settled standards determine whether a financial instrument falls within the investment contract category or the note category. This subsection analyzes swaps under both frameworks, utilizing the Moneylender/Producestuff interest rate swap as a representative swap transaction. This subsection concludes

that most swaps do not fall within either the investment contract or note class of security.

1. Swaps as Investment Contracts

An "investment contract" consists of a contract, transaction, or scheme in which an investor (1) invests his money, (2) in a common enterprise, (3) with the reasonable expectation of profits, (4) derived from the efforts of others.\(^{159}\) Satisfaction of the first prong, investment of money, requires a commitment of assets in such a manner as to subject the investor to financial loss.\(^{160}\) A "common enterprise" under the second prong is present if either of the following situations exists: (a) an enterprise common to the investor and the promoter, seller, or third party ("vertical commonality"), or (b) an enterprise common to a group of investors ("horizontal commonality").\(^{161}\) Vertical commonality exists when the investor's fortunes rise and fall along with those of the promoter, seller, or third party.\(^{162}\) A showing of collective fortunes dependent on the success of a single common enterprise establishes horizontal commonality.\(^{163}\) As to the third prong, a reasonable expectation of profits means either an expectation of capital appreciation or a participation in earnings.\(^{164}\) Profits are derived from the efforts of others, in satisfaction of the fourth element, if the managerial efforts of parties other than the investor are essential to the success or failure of the enterprise.\(^{165}\)

Considering the Moneylender/Producestuff transaction as a representative swap agreement, a court addressing the issue would probably not consider swaps to be investment contracts.\(^{166}\) First, neither Producestuff nor Moneylender made a true commitment of assets in entering into the swap transaction; the parties agreed only to ex-


\(^{161}\) SEC v. R.G. Reynolds, 952 F.2d 1125, 1130 (9th Cir. 1991).


\(^{163}\) Kaplan, 655 F. Supp. at 340.


\(^{165}\) R.G. Reynolds, 952 F.2d at 1131.

change funds at a future date.\textsuperscript{167} Second, the swap does not appear to involve a common enterprise under either the vertical or horizontal test.\textsuperscript{168} The interest rate swap agreement did not result in Producestuff's fortunes being interwoven with Moneylender's and thus failed to satisfy the standard for vertical commonality. In fact, when Producestuff experienced a cash inflow under the swap, Moneylender experienced a cash outflow.\textsuperscript{169} Nor is there the requisite pooling of interests necessary to establish horizontal commonality; there are only two singular parties on opposite sides of a transaction. Furthermore, in entering into the interest rate swap agreement, Producestuff did not expect profits in the form of capital appreciation or participation in earnings. Instead, Producestuff sought to hedge its exposure to interest rate fluctuations and expected returns based only on a floating interest rate.\textsuperscript{170} Finally, any gain accruing to Producestuff under the interest rate swap agreement arose, not from the managerial efforts of others, but from changes in underlying interest rates.\textsuperscript{171}

2. Swaps as Notes

In order to determine whether a financial instrument is a "note" included in the definitions of "security" contained in the 1933 and 1934 Acts, a court must apply the "family resemblance test" articulated by the Supreme Court in \textit{Reves v. Ernst & Young}.\textsuperscript{172} In \textit{Reves}, the Court stated that any "note" with a maturity of more than nine months is a security, unless it resembles one of several instruments not properly viewed as securities.\textsuperscript{173} A court assesses resemblance through consideration of four factors set out in \textit{Reves}.\textsuperscript{174} These four

\textsuperscript{167} See supra part II.A. for a description of the Producestuff/Moneylender swap transaction.


\textsuperscript{169} This situation would arise when the floating rate was below the fixed rate on the agreed upon payment date.


\textsuperscript{171} See id.

\textsuperscript{172} 494 U.S. 56 (1990).

\textsuperscript{173} Reves, 494 U.S. at 65 & n.3. The instruments listed that are not deemed securities include the following:

- [1] the note delivered in consumer financing,
- [2] the note secured by a mortgage on a home,
- [3] the short-term note secured by a lien on a small business or some of its assets,
- [4] the note evidencing a "character" loan to a bank customer,
- [5] short-term notes secured by an assignment of accounts receivable, and
- [6] a note which simply formalizes an open-account debt incurred in the ordinary course of business.

\textit{Id.} at 65 (quoting Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976)).

\textsuperscript{174} Reves, 494 U.S. at 65-67; see Pollack v. Laidlaw Holdings, 27 F.3d 808, 811-12 (2d Cir. 1994).
factors include (1) the motivation of the buyer and seller in entering into the transaction, (2) the plan of distribution of the instrument, (3) the reasonable expectations of the investing public, and (4) whether some element significantly reduces the risk of the instrument, thus rendering application of the securities laws unnecessary ("Reves factors").

The first Reves factor, motivation of the parties, looks to whether the parties entered into the transaction for investment or commercial purposes. Investment purposes indicate that the instrument at issue is a security, while commercial purposes indicate that it falls outside the scope of the federal securities laws. The parties' motivation is investment-related if (1) the seller entered into the transaction to raise money for the general use of a business enterprise or to finance substantial investments, and (2) the buyer entered into the transaction in expectation of a profit. If, however, the purpose of the transaction is to advance commercial purposes such as the facilitation of the purchase and sale of an asset, or the correction of cash-flow difficulties, the motivation factor will weigh against classifying the instrument as a security.

The second Reves factor, the plan of distribution, indicates a security if the instrument at issue is offered to a broad segment of the investing public. If the investing public would generally view the instrument as a security, the third Reves factor weighs in favor of including the instrument within the scope of the federal securities laws. Finally, elements supporting classification of the instrument as a security under the fourth Reves factor include a short maturity and the absence of a separate regulatory scheme governing the purchase and sale of the instrument.

Again using the Moneylender/Producestuff swap transaction as an example, courts would probably not categorize swaps as notes governed by the federal securities laws. First, the motivation of Producestuff and Moneylender in entering into the swap agreement was commercial. Producestuff's intent was to protect against interest rate fluctuations and Moneylender's purpose was to earn its fee and provide a service to a long-term banking customer. Moreover, Moneylender did not intend the swap for distribution to a broad segment.

177. Id.
178. *Reves*, 494 U.S. at 66. For purposes of the analysis under the first Reves factor, interest payments can be considered "profit." Id. at 68 n.4.
179. Id. at 66.
183. *See* *Reves*, 494 U.S. at 67; *Banco Espanol*, 763 F. Supp. at 43.
184. *See* Greene, supra note 158, at 820.
of the investing public. Instead, the swap agreement was a privately negotiated transaction between two corporate entities. The absence of an "investing public" with respect to the interest rate swap indicates that the third Reves factor weighs against classifying the swap as a security. Finally, the fourth Reves factor also appears to keep the swap outside the scope of the federal securities laws. The term of the swap was fifteen years and Moneylender's activities are subject to oversight by federal banking regulators.\textsuperscript{185}

Thus, although the definitions of "security" found in the 1933 and 1934 Acts are "broadly construed by ... courts ... to afford the investing public a full measure of protection,"\textsuperscript{186} swaps do not appear to fall within these definitions. Swaps are usually unique, privately negotiated, nontransferable instruments that are not offered to the public. Such instruments are not generally considered securities by the investment community or the federal securities laws.\textsuperscript{187}

C. Swaps as Futures

Swap agreements have some economic features similar to futures contracts, thus potentially bringing swaps under the exclusive jurisdiction of the CFTC.\textsuperscript{188} Interest rate swaps, for example, exhibit functions and effects analogous to futures contracts on T-bills and T-bonds.\textsuperscript{189} Both interest rate swaps and treasury futures are dependent on interest rate movements and are often used to hedge against exposure to such fluctuations.\textsuperscript{190} Additionally, treasury futures, similar to interest rate swaps, are frequently settled by cash payments.\textsuperscript{191} Finally, clauses in swap agreements requiring the deposit and maintenance of collateral are similar to initial and maintenance margin requirements present in futures trading.\textsuperscript{192}

Swaps, however, lack several identifying characteristics of CFTC-regulated futures contracts.\textsuperscript{193} The terms of exchange-traded futures contracts are standardized, while swap agreements have few, if any, standardized terms.\textsuperscript{194} Additionally, futures contracts allow for daily

\textsuperscript{185} See infra note 209 and accompanying text.
\textsuperscript{187} See Mace Neufeld Prods. v. Orion Pictures Corp., 860 F.2d 944, 946 (9th Cir. 1988) (noting that an agreement that is "not publicly offered or traded,... unique, and ... negotiated 'one-on-one' by the parties" is not a security under the federal securities laws).
\textsuperscript{188} See Greene, supra note 158, at 840. For a discussion of the CFTC's exclusive jurisdiction over futures trading, see supra note 120.
\textsuperscript{189} Gilberg, supra note 166, at 1646. Futures contracts on T-bills and T-bonds are subject to the exclusive jurisdiction of the CFTC. See supra note 120 and accompanying text.
\textsuperscript{190} See id.
\textsuperscript{191} Id. at 1647.
\textsuperscript{192} Id.
\textsuperscript{193} Id.
\textsuperscript{194} Id.
marking to market;\textsuperscript{195} swap agreements do not provide for any such arrangement.\textsuperscript{196} Moreover, large commercial entities generally negotiate swap agreements among themselves for hedging purposes specific to their lines of business.\textsuperscript{197} By contrast, investment professionals regularly market futures to the public and individual investors often use futures for speculative purposes.\textsuperscript{198}

The CFTC recognizes these important distinctions between futures contracts and swap transactions and has expressed its intent not to bring swaps under CFTC jurisdiction.\textsuperscript{199} In 1989, through issuance of its Policy Statement Concerning Swap Transactions,\textsuperscript{200} the CFTC indicated that it would not attempt to regulate swaps. Subsequently, under authority granted by the Futures Trading Practices Act of 1992,\textsuperscript{201} the CFTC exempted certain swap agreements from its oversight.\textsuperscript{202} Currently, swaps with the following characteristics are excluded, for the most part, from the CFTC's jurisdiction: (1) the parties to the swap are "eligible swap participants;"\textsuperscript{203} (2) the swap is not part of a fungible class of agreements standardized as to their material economic terms; (3) counterparty creditworthiness was a material consideration of the parties in entering into the swap agreement; and (4) the swap was not entered into and is not traded on, or through, an exchange market ("CFTC Swap Exemption").\textsuperscript{204} The majority of swap agreements possess these characteristics and thus will be exempt from most CFTC regulation.\textsuperscript{205}

For example, the Moneylender/Producestuff interest rate swap would likely be exempt under the CFTC Swap Exemption. Both parties to the Swap Agreement are eligible swap participants. Money-

\textsuperscript{195} For an explanation of marking to market, see supra note 118.

\textsuperscript{196} See Gilberg, supra note 166, at 1647-48.

\textsuperscript{197} See id. at 1648.

\textsuperscript{198} See Hull, supra note 2, at 8-9.


\textsuperscript{200} Id.

\textsuperscript{201} Pub. L. No. 102-546, 106 Stat. 3590 (codified at 7 U.S.C. § 6(c)-(d) (1994)).

\textsuperscript{202} 17 C.F.R. § 35 (1995).

\textsuperscript{203} The following are considered "eligible swap participants" for purposes of exemption of swaps from CFTC regulation: (1) a bank or trust company; (2) a savings association or credit union; (3) an insurance company; (4) an investment company subject to regulation under the Investment Company Act of 1940; (5) a commodity pool subject to regulation under the CEA; (6) a corporation, partnership, proprietorship, organization, trust or other entity meeting certain financial requirements; (7) an employee benefit plan subject to ERISA; (8) a governmental entity or political subdivision thereof; (9) a broker-dealer subject to regulation under the 1934 Act; (10) a futures commission merchant, floor broker, or floor trader subject to regulation under the CEA; or (11) any natural person with total assets exceeding at least $10,000,000. 17 C.F.R. § 35.1(b)(2) (1995).

\textsuperscript{204} 17 C.F.R. § 35.2 (1995). Certain sections of the CEA, including the antifraud provisions, apply even to swaps exempted under § 35.2. See id.

\textsuperscript{205} See Gilberg, supra note 166, at 1647-48.
lender is a bank,\(^{206}\) and Producestuff is a corporation with a net worth in excess of $1,000,000 that is entering into the swap agreement to manage the risk associated with its bond payments and distribution contracts.\(^{207}\) Moreover, the interest rate swap contains privately-negotiated terms and thus is not part of a standardized fungible class of agreements. The Swap Agreement embodying the terms of the swap expressly states that counterparty creditworthiness was a material consideration for each party in entering into the swap transaction. Finally, Moneylender designed the swap for, and offered it exclusively to, Producestuff. The swap was not entered into on, or traded on or through, an organized exchange. Thus, the Moneylender/Producestuff swap transaction appears not to fall under the jurisdiction of the CFTC.

D. Federal Regulation of Swaps Recommended by Banks

A bank recommending a swap transaction will be subject to oversight by one or more federal banking regulators.\(^{208}\) Nationally chartered banks are regulated by the OCC.\(^{209}\) Federal Reserve member banks with state charters are overseen by the Federal Reserve\(^ {210}\) and state banking authorities.\(^{211}\) A state chartered bank that is not a member of the Federal Reserve, but that is insured by the Federal Deposit Insurance Corporation ("FDIC"), is regulated by the FDIC and state banking authorities.\(^ {212}\) Thrifts are subject to oversight by the Office of Thrift Supervision, and by the OCC or state banking authorities, depending on whether the thrift is nationally or state chartered.\(^ {213}\) The majority of banks that regularly enter into swap transactions are regulated either by the OCC, as is Moneylender, or by the Federal Reserve and state banking authorities.\(^ {214}\)

In October 1993, the OCC issued a banking circular ("BC-277") that provided guidance to national banks regarding risk management of derivatives activities.\(^ {215}\) BC-277 states that a bank proposing a de-

\(^{206}\) See 17 C.F.R. § 35.1(b)(2)(i) (1995) (including banks within the definition of "eligible swap participant").

\(^{207}\) See 17 C.F.R. § 35.1(b)(2)(vi) (1995) (including certain large corporations within the definition of "eligible swap participant").


\(^{211}\) GAO Report, supra note 208, at 69.


\(^{214}\) See GAO Report, supra note 208, at 70.

\(^{215}\) Risk Management of Financial Derivatives, BC-277, Oct. 27, 1993, available in 1993 WL 640326 (OCC) [hereinafter BC-277]. BC-277 defines derivatives as "financial instruments which derive their value from the performance of assets, interest or currency exchange rates, or indexes" and explicitly includes swaps within this definition. Id. at *2.
derivatives transaction to a customer should (1) be able to identify whether the transaction is consistent with the customer's policies and procedures as they are known to the bank, (2) be able to effectively analyze the impact of the proposed transaction on the financial condition of the customer, and (3) understand the applicability of derivative instruments to the risks the customer is attempting to manage.\textsuperscript{216} The OCC, however, does not prohibit banks from entering into a derivatives transaction that it feels is inappropriate for the customer.\textsuperscript{217} Instead, BC-277 merely requires a bank to document the analysis and information provided to the customer if the customer proceeds with an inappropriate transaction.\textsuperscript{218}

The investment community originally viewed BC-277 as including a suitability rule applicable to swap transactions recommended by banks.\textsuperscript{219} Subsequent to the issuance of BC-277, however, the OCC issued a bulletin specifically stating that BC-277 does not contain a suitability rule.\textsuperscript{220} In this bulletin, the OCC did acknowledge that a bank recommending a derivative transaction should understand the risk the customer is trying to manage or assume in entering into the transaction.\textsuperscript{221} Additionally, the bulletin indicated that a bank should ensure that the customer understands the nature and risk of the derivatives transaction, and should explain how the transaction will achieve the customer's objectives.\textsuperscript{222} Nonetheless, the OCC stated explicitly that BC-277 does not impose a suitability rule on banks recommending derivatives transactions.\textsuperscript{223}

### III. Recommendations for Uniform Regulation of the Suitability of Derivatives Transactions

There currently exists no comprehensive regulatory framework that protects customers such as Middlemanager, Leisure, and Producestuff from recommendations of unsuitable derivatives transactions. The NASD and exchange suitability rules provide guidelines for addressing the suitability of options transactions and allow for disciplinary proceedings against registered representatives that violate these rules.\textsuperscript{224} The NASD and exchange rules, however, do not provide a private cause of action for customers injured by unsuitable recommen-

\textsuperscript{216} BC-277, supra note 215, at *7.
\textsuperscript{217} Id.
\textsuperscript{218} Id.
\textsuperscript{221} Id. at *14.
\textsuperscript{222} Id.
\textsuperscript{223} Id. at *11-12; see Bank Agencies Drafting Suitability Rule Covering Bank Sales of Structured Notes, 63 Banking Rep. (BNA) No. 20, at 772 (Nov. 28, 1994).
\textsuperscript{224} See supra notes 73-102 and accompanying text.
Liability under section 10(b) and Rule 10b-5 based solely on unsuitable recommendations is difficult to establish. The CFTC, which has exclusive jurisdiction over transactions in futures contracts, does not currently have a suitability rule. Swaps do not fall under the jurisdiction of either the federal securities laws or the CFTC. Swap transactions recommended by banks are subject to oversight by federal banking regulators. These regulators, however, do not impose a legal duty on banks to recommend only suitable transactions.

In order to adequately protect the public from recommendations of unsuitable derivatives transactions, a comprehensive derivatives suitability rule should be established. This part discusses the viability of imposing such a rule. Section A examines the policy considerations surrounding the promulgation of a derivatives suitability rule. Section B discusses bills pending in Congress that contain provisions allowing for the enactment of a comprehensive derivatives suitability rule. Section C proposes a model derivatives suitability rule and section D applies this model rule to the situations of Middlemanager, Leisure, and Producestuff.

A. Policy Considerations

Some commentators contend that imposing a legal duty on investment professionals to recommend only suitable derivatives transactions is unnecessary and unwise. These commentators advance several arguments in support of their position. First, they note that suitability is often difficult to determine. The information required to make such a determination may be burdensome to obtain and verify, and may rapidly become outdated. Additionally, commentators arguing against a derivatives suitability rule contend that sufficient customer protection, in the form of disclosure and antichurning rules, and the common law doctrine of fiduciary duty, is already in place. Finally, according to these commentators, suitability requirements encourage unnecessary litigation and hurt the United States' competitiveness in the international derivatives market.

These arguments, however, are flawed and outweighed by arguments supporting the adoption of suitability standards for derivatives.

225. See Jablon v. Dean Witter & Co., 614 F.2d 677, 680 (9th Cir. 1980).
226. See supra notes 109-11 and accompanying text.
227. See supra notes 120-47 and accompanying text.
228. See supra notes 158-207 and accompanying text.
229. See supra notes 208-14 and accompanying text.
230. See supra notes 215-23 and accompanying text.
231. Greenough, supra note 21, at 1006.
232. Id.
233. Id. at 1007.
234. Id. at 1007-08.
235. Blackman, supra note 30, at 5.
transactions. First, investment professionals governed by the NASD and exchange suitability rules currently assess the suitability of options transactions, indicating that determining suitability is not an insurmountable task. Additionally, disclosure and antichurning rules do not adequately protect customers. Disclosure rules are no match for aggressive selling on the part of unscrupulous investment professionals and churning is simply one of many categories of unsuitable practices. Moreover, investment professionals should be responsible for assessing suitability because of their special relationship with the investing public. The public is encouraged to, and does, rely on the superior skill of the investment community in its financial transactions. This factor is especially important in light of the complicated and risky nature of derivative instruments. Finally, adoption of a comprehensive derivatives suitability rule may actually assist investment professionals. Compliance with an established suitability rule could serve as a defense to a customer's claim of unsuitable recommendations. Additionally, a suitability rule would put investment professionals on notice of what governing agencies expect of them, thus allowing for the adoption of procedures to guard against potential liability.

B. Pending Legislation

At the time of publication of this Note, two bills are pending in the 104th Congress that would allow for the development and implementation of a comprehensive derivatives suitability rule. First, on January 4, 1995, Jim Leach (R-Iowa) introduced the Risk Management Improvement and Derivatives Oversight Act of 1995 ("Derivatives Oversight Act") in the House of Representatives. The purpose of this pending legislation is to establish principles and standards for the supervision by federal regulators of financial institutions engaged in derivatives activities. The Derivatives Oversight Act would create a Federal Derivatives Commission ("FDC") consisting of (1) the Chairman of the Board of Governors of the Federal Reserve System, (2) the Comptroller of the Currency, (3) the Chairman of the Board of Directors of the FDIC, (4) the Director of the Office of Thrift Super-
vision, (5) the Chairman of the SEC, (6) the Chairman of the CFTC, and (7) the Secretary of the Treasury. Additionally, the Derivatives Oversight Act mandates that the FDC establish principles and standards regarding, among other issues, suitability. The regulatory agencies comprising the FDC would be required, under the Derivatives Oversight Act, to issue and enforce regulations necessary to implement these standards. Finally, the Derivatives Oversight Act provides that the derivatives activities of any financial institution not subject to supervision by either a federal banking agency or the CFTC shall be supervised by the SEC.

Also on January 4, 1995, Henry Gonzalez (D-Texas) introduced the Derivatives Safety and Soundness Supervision Act of 1995 ("Derivatives Supervision Act") in the House of Representatives. This bill, like the Derivatives Oversight Act, seeks to increase federal agency oversight of derivatives activities. The Derivatives Supervision Act does not provide for the establishment of an interagency derivatives commission. It does, however, mandate that federal regulatory agencies, in consultation with each other, establish substantially similar standards regarding, among other issues, the suitability of derivatives transactions.

C. A Model Uniform Derivatives Suitability Rule

The Derivatives Oversight Act and the Derivatives Supervision Act both provide for comprehensive regulation of derivatives trading. Additionally, the pending legislation requires federal regulatory agencies to establish suitability standards governing derivatives transactions. Parts I and II of this Note demonstrate that the current suitability rules do not adequately protect the public from unsuitable investments in derivatives. Thus, Congress should enact either the Derivatives Oversight Act or the Derivatives Supervision Act and the appropriate regulatory bodies should promulgate a derivatives suitability rule. This section proposes a model derivatives suitability rule that addresses issues discussed earlier in this Note. Additionally, this section highlights the strengths of the proposed model rule.

245. Id. § 103(a).
246. Id. § 104(a)(1)(D).
247. Id. § 104(a)(2).
250. Id. § 101.
251. Id. § 101(a). The federal regulatory agencies charged with establishing standards under the Derivatives Supervision Act include the agencies that make up the FDC under the Derivatives Oversight Act. See id. § 2(3).
252. The model rule is the product of research and study undertaken by the author of this Note.
1. A Model Derivatives Suitability Rule

RULE 101. SUITABILITY OF DERIVATIVES TRANSACTIONS
Section A. Definitions
(1) Customer: For purposes of this rule, a “customer” is the party entering into the derivatives transaction with the dealer.
(2) Customer Representative: For purposes of this rule, a “customer representative” is the natural person to whom a recommendation is directed. The “customer” and “customer representative” can be the same person.
(3) Derivative: For purposes of this rule, the term “derivative” includes any financial instrument the value of which is derived from the value of an underlying instrument. “Derivative” includes, but is not limited to, options, futures, and swaps.
(4) Recommendation: For purposes of this rule, the term “recommendation” means any recommendation to buy, sell, or maintain any derivatives position, or the recommendation of any specific derivatives investment strategy. “Recommendation” does not include the execution of an unsolicited transaction.

Section B. Responsibilities of Investment Professionals
(1) Prior to recommending to a customer representative any transaction involving a derivative, an investment professional must:
   (a) determine that such recommendation is suitable for the customer in light of the customer’s financial situation and objectives;
   (b) ensure that the customer representative fully understands the nature and risks of the recommended transaction; and
   (c) ensure that the customer can withstand the potential loss inherent in the recommended transaction.

Section C. Information Necessary to Determine Suitability
(1) An investment professional has an affirmative duty to obtain information regarding a customer’s financial situation and objectives prior to recommending a derivatives transaction.
(2) The information that must be obtained includes, but is not limited to, the following:
   (a) the customer’s net worth;
   (b) the customer’s income or cash flow;
   (c) the customer’s current liabilities;
   (d) the customer’s financial responsibilities;
   (d) the customer’s financial objectives; and
   (e) the customer’s and customer representative’s prior investment experience.
(3) Information regarding a customer’s financial situation and objectives must be obtained throughout the investment professional’s relationship with the customer.
(4) The investment professional must keep a written record of all relevant information.
Section D. Consequences of Violation

An investment professional found guilty of violating this rule shall:

(1) be subject to disciplinary sanctions; and
(2) be liable to the injured customer for actual damages in a court of law or arbitration proceeding.

2. Benefits of Rule 101

Rule 101 provides a comprehensive framework governing the suitability of recommended derivatives transactions. Section A of the rule defines "derivative" to include all derivative instruments within its scope. This broad definition avoids the problem of determining what regulations govern swap transactions, and other similar new types of investments, by including them in the definition of derivative. Section A also distinguishes between a "customer" and a "customer representative." This distinction requires investment professionals to take steps to ensure that the individual to whom the derivatives transaction is proposed fully understands the nature and risks of the transaction. Finally, in order to avoid imposing unduly burdensome duties on investment professionals, Section A excludes all unsolicited transactions from the definition of "recommendation."

Section B of Rule 101 clearly outlines an investment professional's obligations in recommending a derivatives transaction—(1) to determine the suitability of the transaction, (2) to ensure that the customer representative fully understands the transaction, and (3) to ensure that the customer can withstand the potential losses inherent in the transaction. Section C imposes an affirmative duty on investment professionals to obtain from customers the information necessary to satisfy the requirements of Section B. Additionally, Section C provides a nonexclusive list of required information that an investment professional must obtain from the customer. Section C also mandates that the investment professional gather such information on an ongoing basis and record it in writing.

Section D subjects investment professionals in violation of Rule 101 to disciplinary sanctions. Additionally, Section D provides a private cause of action to customers injured by the recommendation of unsuitable derivatives transactions.

D. Application of Rule 101 to the Hypothetical Transactions

Parts I and II illustrated that Middlemanager, Leisure, and Producestuff are not adequately protected under the current suitability rules. Rule 101, however, provides protection against unsuitable derivatives similar to those investments recommended by Richbroker, Futuresdealer, and Moneylender. The following subsections apply Rule 101 to the situations of the three hypothetical clients.
1. The Richbroker/Middlemanager Options Transaction

The suitability obligations placed on investment professionals under Rule 101 are similar to those imposed by the NASD and SRO rules that currently govern options transactions. Application of the NASD and SRO rules to the Richbroker/Middlemanager transaction demonstrates that Richbroker would be subject to disciplinary actions under these rules. Thus, Richbroker's actions also violate Rule 101. Rule 101, however, provides Middlemanager with a remedy for his injuries suffered as a result of Richbroker's unsuitable recommendation.

2. The Futuresdealer/Leisure Futures Transaction

Leisure would also have a cause of action against Futuresdealer and Commodityco under Rule 101. First, Futuresdealer failed to satisfy Section C of the rule because she did not obtain from Leisure the information necessary to determine suitability. The only knowledge of Leisure's finances that Futuresdealer had in making the recommendation was that Leisure had $125,000 of risk capital to invest. Futuresdealer knew nothing further about Leisure's financial situation and objectives.

Additionally, the risky futures contracts recommended to Leisure by Futuresdealer were definitely not suitable for a retired person on a fixed income. Though Leisure was interested in growth investments, he did not necessarily desire to speculate with gold futures. Moreover, Futuresdealer did not take steps to ensure that Leisure understood fully the nature and risks of futures trading. The risk disclosure statement provided by Leisure did not satisfy Futuresdealer's obligations under Rule 101. Futuresdealer could attempt to argue that Leisure had the requisite knowledge because he was well-educated and had purchased futures on two prior occasions. These factors, however, did not mean that Leisure fully understood the futures transaction recommended by Futuresdealer.

Finally, Futuresdealer did not ensure that Leisure could withstand the potential loss inherent in gold futures. All Futuresdealer knew was that Leisure had $125,000 of risk capital. Leisure deposited $100,000 of these funds to satisfy the initial margin requirement. If the position moved against him, as it did, Futuresdealer had no assurance that Leisure could meet margin calls. Thus, it appears that Futuresdealer violated Rule 101, subjecting herself and Commodityco to sanctions and civil liability.

253. See supra notes 73-82 and accompanying text.
254. See supra notes 83-102 and accompanying text.
3. The Moneylender/Producestuff Swap Transaction

Moneylender's recommendation of the interest rate swap to Producestuff is also a violation of Rule 101. While Moneylender's long-term banking relationship with Producestuff indicates that Moneylender had the necessary information to determine suitability, the recommended swap was not a suitable transaction in light of Producestuff's financial situation and objectives. First, Financeman expressly indicated that it wanted to make payments paralleling the commercial paper rate. The complex formula upon which Producestuff's swap payments were based did not mirror the commercial paper rate. Financeman also stated that Producestuff desired to make payments at relatively frequent intervals. Payments under the swap agreement were to be made only twice a year. Moreover, while the distributorship contracts necessitating the swap could be renegotiated every two years, the swap had a term of fifteen years.

Additionally, while Moneylender did define swaps for the Producestuff finance department, the bank took no further steps to explain the nature of the specific interest rate swap recommended. This explanation was especially important considering that only Financeman had any extensive knowledge of swaps. Thus, Moneylender's recommendation was unsuitable, subjecting the bank to sanctions and providing Producestuff with a cause of action under Rule 101.

Conclusion

Derivatives provide benefits to both investors and dealers. Numerous companies currently utilize derivative instruments to hedge the risks of their business operations and to increase investment earnings. Additionally, derivatives activity has increased the profits of broker-dealers and banks. These positive effects, however, are accompanied by a downside. Both consumers and dealers of derivatives recently experienced significant losses from derivatives activity.

Derivatives, and the news surrounding their use, bring to the forefront two significant issues. First, derivatives demonstrate the fragmentation of the law governing the investment community. Entirely separate regulatory frameworks govern the two most common types of derivatives—options and futures. Furthermore, courts are undecided regarding the rules that should govern swap transactions. Certain features, however, are common to all types of derivative products. Thus, the various financial regulatory agencies should cooperate in the oversight of the derivatives market under a consistent set of rules.

Additionally, derivatives show that the complexity of new financial products can invalidate current rules. Derivatives are used mostly by large institutional investors that are considered sophisticated customers. Investment professionals are generally not required to determine
the suitability of products recommended to sophisticated investors. Thus, under the current rules, derivatives dealers often do not have to ascertain whether the derivatives transactions they recommend are appropriate for their customers. The complicated nature of derivative instruments and the extreme risk underlying their use, however, make some derivatives transactions unsuitable even for sophisticated investors. The duty to determine suitability should be placed on investment professionals who understand complex derivatives transactions.

The Derivatives Oversight Act and the Derivatives Supervision Act provide for cooperative regulation of the derivatives market. Rule 101, as proposed in this Note, places necessary obligations on derivatives dealers to determine the suitability of transactions for their customers. To prevent the problems created by derivatives from overcoming the usefulness of these new financial products, Congress should enact the pending derivatives legislation and the appropriate agencies should then promulgate a rule similar to Rule 101.